STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
PROPERTY TAXES DEPARTMENT
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September 1, 2000

TO INTERESTED PARTIES:

REVIEW OF POSSESSORY INTEREST REGULATIONS:
PROPERTY TAX RULES 21, 22, 23, 24, 25, 26 and 28

The Board is currently reviewing Property Tax Rules 21, 22, 23, 24, 25, 26, and 28 relating to the assessment of taxable possessory interests. (Although they also address possessory interests, rules 20 and 27 are outside of the scope of this project. Rule 20 was recently revised, in 1998, and rule 27 involves the valuation of taxable possessory interests for the production of hydrocarbons, a specialized area.) The structure of the current revision is as follows:

- Rules 21, 23, 24, 25, and 26 will be combined into a single rule—proposed new rule 21—that addresses the same concepts covered in these existing rules.
- Rule 22 and 28 will remain in effect unchanged.

A copy of proposed new rule 21 is enclosed. Interested parties may submit proposed changes to the rule language in the form of alternative text. Proposed changes will be accepted until October 13, 2000. Staff will review any suggested changes and will incorporate those that they believe to be appropriate. Prior to the interested parties meeting, staff will distribute a matrix that contains comments and alternative language submitted by interested parties with staff's corresponding positions.

On December 5, 2000, staff will meet with interested parties to discuss the contents of the matrix. The purpose of this meeting is to reach agreement on rule language. The meeting will be held at 9:30 a.m. in Room 122, Board of Equalization, 450 N Street, Sacramento. Unresolved differences, if any, will be presented to the Property Tax Committee in early 2001 for resolution.

Please submit any proposed changes to Paul Lane, Policy, Planning, and Standards Division (e-mail: paul.lane@boe.ca.gov; facsimile: (916) 323-8765). If you have any questions, please contact Mr. Lane at (916) 324-5828 or Mr. Benjamin Tang at (916) 324-2720.

Sincerely,

/s/ Richard C. Johnson
Richard C. Johnson
Deputy Director
Property Taxes Department

RCJ:bt
Enclosure

Rule 21. TAXABLE POSSESSORY INTERESTS—VALUATION

Reference: Sections 107 and 107.1, Revenue and Taxation Code

(a) Definitions. For the purposes of this regulation:

(1) “Real property” has the same meaning as defined in rule 20(c)(1).

(2) “Possession” has the same meaning as defined in rule 20(c)(2).

(3) A “right” to the possession of real property includes a “claim to a right” to the possession of real property within the meaning of rule 20(c)(3).

(4) “Possessor” has the same meaning as defined in rule 20(c)(4).

(5) The “term of possession” of a taxable possessory interest means the term of possession for valuation purposes.

(6) The “stated term of possession” for a taxable possessory interest as of a specific date is the remaining period of possession as of that date as specified in the lease, agreement, deed, conveyance, permit, or other authorization or instrument that created, extended, or renewed the taxable possessory interest, including any option or options to renew or extend the specified period of possession if it is reasonable to assume that the option or options will be exercised.

(7) "Contract rent" means any compensation or payments that are required to be paid or provided by a possessor in cash or its equivalent under an authorization or instrument that creates a taxable possessory interest for the property rights provided by the taxable possessory interest. Contract rent includes the value that the public owner is expected to realize from improvements erected at the expense of the possessor that will remain when the taxable possessory interest terminates. As defined in this regulation, contract rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of “gross outgo” under subsection (c) of rule 8.

(8) "Economic rent" means the estimated amount that would be paid by the possessor, on the valuation date in cash or its equivalent, for the property rights provided by the taxable possessory interest if (i) the right to possession were offered in an open and competitive market and (ii) the public owner’s interest in the property were not exempt or immune from taxation. As defined in this regulation, economic rent is net of those operating expenses necessary to maintain the income from the taxable possessory interest, whether paid by the possessor or the public owner, including those expenses within the definition of “gross outgo” under subsection (c) of rule 8.

(9) "Creation” means the creation of a taxable possessory interest. Creation includes (i) an initial grant or other conveyance of a taxable possessory interest; (ii) a subsequent grant or other conveyance of additional land or improvements to a preexisting taxable possessory

interest; or (iii) a subsequent grant or conveyance of additional valuable property uses not previously permitted by the possessor.

(10) "Extension or renewal" means the lengthening of the period of possession of a taxable possessory interest, such as by the exercise of an option to extend or to renew a lease or permit.

(b) Rights to be Valued. Except as provided in subsection (f) or specifically provided otherwise by law, the fair market value of a taxable possessory interest is the value of all property rights in real property held by the possessor.

(1) The fair market value of a taxable possessory interest is not diminished by any obligation of the possessor to pay rent or to retire debt secured by the taxable possessory interest. In other words, the fair market value of a taxable possessory interest is the fair market value of the fee simple absolute interest reduced only by the value of the property rights, if any, granted by the public owner to other persons and by the value of the property rights retained by the public owner (excluding the public owner's right to receive rent).

(2) Examples of property rights that may be granted or retained by the public owner include the following: (i) the right to take possession of the property upon the termination of the taxable possessory interest due to the occurrence of an event such as the expiration of the contract term, a breach of agreement, or the happening of a condition that terminates the possessor's right to possession; (ii) the right to put the property to a higher and better use or otherwise restrict the possessor's use of the property; (iii) the right to terminate possession upon notice; (iv) the right to approve a sublessee or assignee; and (v) the right to approve a loan secured by the taxable possessory interest.

(c) Standard of Value. Assessors shall value a taxable possessory interest consistent with the requirements of subsections (a), (d), (e), and (f) of section 110 of the Revenue and Taxation Code. A taxable possessory interest subject to article XIII A of the California Constitution shall also be valued consistent with the requirements of section 110.1 of the Revenue and Taxation Code.

(d) Term of Possession for Valuation Purposes

(1) The term of possession for valuation purposes shall be the stated term of possession unless there is evidence demonstrating that the reasonably anticipated term of possession will be shorter or longer than the stated term of possession. Evidence demonstrating that the reasonably anticipated term of possession is shorter or longer than the stated term of possession must go beyond mere possibility or the unsubstantiated expectations of the parties or others.

(2) In determining the reasonably anticipated term of possession, the assessor shall be guided by the intent of the public owner and the possessor, as well as by the intent of similarly situated parties, as evidenced by the following criteria:

(A) The sale price of the subject taxable possessory interest and sales prices of comparable taxable possessory interests.

(B) The rules, policies, and customs of the public owner and of similarly situated public owners.

(C) The history of the subject taxable possessory interest's use and the histories of the uses of comparable taxable possessory interests.

(D) The history of the relationship of the parties to the subject taxable possessory interest and the histories of the relationships of similarly situated parties.

(E) The actions of the parties to the subject taxable possessory interest, including any amounts invested in improvements by the public owner or the possessor.

(3) If there is no stated term of possession, the term of possession for valuation purposes shall be the reasonably anticipated term of possession as determined in accordance with subsection (d)(2).

(e) Valuation of Post-De Luz Taxable Possessory Interests. Except as specifically provided otherwise by law, and excluding a taxable possessory interest involving the production of gas, petroleum, or other hydrocarbons, the value of a taxable possessory interest created, extended, or renewed after December 24, 1955 (i.e., a "Post-De Luz" taxable possessory interest) may be estimated using one or more of the following methods, as appropriate for the taxable possessory interest being valued.

(1) Comparative Sales Approach to Value. In the comparative sales approach, a taxable possessory interest is valued using the sale price of the subject taxable possessory interest or sales prices of comparable taxable possessory interests, provided such interests shall have sold under the conditions of fair market value described in subsection (a) of section 110. A taxable possessory interest may be valued by the direct comparison method or the indirect comparison method.

(A) Direct Comparison Method

1. In the direct comparison method, the appraiser shall add the following to the sale price of the subject taxable possessory interest, or to the sale price of a comparable taxable possessory interest, to derive an indicator of the fair market value of the subject taxable possessory interest: (i) the present value on the sale date of any unpaid future contract rent for the term of possession; (ii) the fair market value on the sale date of any debt assumed by the buyer of the taxable possessory interest; and (iii) the present value on the sale date of any future costs that the buyer is contractually obligated to pay for the right of possession (e.g., the cost of site restoration at the end of the term of possession) less the present value on the sale date of any future benefits in addition to the right of possession or use that the buyer

is contractually entitled to receive (e.g., the salvage value of, or reimbursement value for, improvements existing at the end of the term of possession).

2. When valuing a taxable possessory interest by comparison with the sales of other taxable possessory interests, the other taxable possessory interests shall be located sufficiently near the subject taxable possessory interest and shall be sufficiently alike in respect to character, size, situation, usability, zoning or other legal restriction as to use (unless rebutted pursuant to section 402.1) to make it clear that the comparable taxable possessory interests and the subject taxable possessory interest are comparable in value and that the cash equivalent price realized for the comparable taxable possessory interests may fairly be considered as shedding light on the value of the subject taxable possessory interest. The comparable sales also shall be sufficiently near in time to the valuation date of the subject taxable possessory interest. “Near in time to the valuation date’’ does not include any sale more than 90 days after the lien date.

(B) Indirect Comparison Method. In the indirect comparison method, a taxable possessory interest is valued by (i) estimating the value of the possessor’s property rights in the taxable possessory interest as if owned in perpetuity (i.e., the value of the fee simple absolute interest in such rights) using sales of fee interests in properties that are comparable to the subject property as prescribed in section 402.5 and whose highest and best use corresponds to, or is comparable with, the permitted use of the subject taxable possessory interest; and (ii) reducing this value by the present value of those property rights for the period subsequent to the term of possession (i.e., the value of the fee simple absolute interest in such rights at the end of the term of possession). The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.

(2) Cost Approach to Value. In the cost approach, a taxable possessory interest is valued by (i) adding the estimated replacement cost new less depreciation of improvements that meet the requirements of the possessor’s permitted use to the estimated value of the taxable possessory interest in land; and (ii) subtracting the present value of the estimated improvement value at the end of the term of possession, if any, from this amount.

(A) The replacement cost new less depreciation of the improvements may be estimated as prescribed in subsections (d) and (e) of rule 6. The estimated value of the taxable possessory interest in land may be estimated using the comparative sales approach (direct or indirect method) or the income approach (direct or indirect method), as prescribed in subsections (e)(1) and (e)(3).

(B) If a possessor’s property use is limited to specified time periods (e.g., certain hours of the day, certain days of the week, etc.), or is shared concurrently with other possessors, the value determined by the cost approach shall be reasonably allocated to each possessor in a manner that reflects each possessor’s proportionate value of the right to possession.

(3) Income Approach to Value. In the income approach, a taxable possessory interest is valued by discounting the future net income that the interest is capable of producing. A taxable

possessory interest may be valued using the direct income method or the indirect income method.

(A) Direct Income Method. In the direct income method, a taxable possessory interest is valued by capitalizing the future net income that the taxable possessory interest is capable of producing under typical, prudent management for the term of possession. The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.

(B) Indirect Income Method. In the indirect income method, a taxable possessory interest is valued by (i) estimating the fair market value of the possessor's rights on the valuation date as if owned in perpetuity (i.e., the value of the fee simple absolute interest in such rights) using the income approach to value as prescribed in rule 8; and (ii) subtracting from this amount the present value of the those rights in the subject property for the period subsequent to the term of possession. The resulting amount is an indicator of the fair market value of the subject taxable possessory interest.

(C) Net Income to be Capitalized. The net income to be capitalized in the valuation of a taxable possessory interest may be (i) the estimated economic rent for the subject taxable possessory interest; or (ii) if such evidence is unreliable or unavailable, the estimated net operating income of a typical, prudent operator of the property subject to the taxable possessory interest. The estimated economic rent or estimated net operating income must reflect the restrictions on use inherent in the subject taxable possessory interest.

1. Economic rent

a. The economic rent of the subject taxable possessory interest may be estimated by reference to (i) the contract rent for the subject taxable possessory interest; (ii) contract rents for comparable taxable possessory interests; or (iii) contract rents for comparable fee simple absolute interests in real property. All such contract rents shall have been negotiated in an open and competitive market involving real property reasonably comparable to the subject taxable possessory interest in terms of physical attributes, location, legally enforceable restrictions on the property's use, term of possession, and risk of cancellation of the taxable possessory interest by public owner; and shall have been negotiated sufficiently near in time to the valuation date of the subject taxable possessory interest.

b. When using the contract rent of a taxable possessory interest as an indicator of the economic rent of a taxable possessory interest, the assessor shall add to the contract rent (i) an estimate of the amount, if any, by which the contract rent has been reduced because improvements have been constructed at the possessor's expense that will revert to the public owner at the end of the term of possession; and (ii) an estimate of the amount, if any, by which the contract rent has been reduced because the possessor will bear the cost of restoring the real property to its original condition on reversion to the public owner, or of removing improvements (less any estimated salvage value), or of any similar obligation.

2. Net Operating Income

a. In deriving the net income to be capitalized, rental income is preferable to operating income (i.e., income from operating a business) because operating income may be influenced by managerial skills and may derive, in part, from nontaxable property. If there is no reliable evidence of the economic rent for the subject taxable possessory interest, however, the net income to be capitalized may be based on the estimated net operating income of the subject taxable possessory interest.

b. Net operating income is gross operating income less allowed expenses. Gross operating income, allowed expenses, and net operating income are defined herein consistent with “gross return,” “gross outgo,” and “net return,” respectively, in subsection (c) of rule 8.

c. When valuing a taxable possessory interest, allowed expenses include the following: cost of goods sold (if applicable), typical operating expenses, typical management expense, an allowance for a return on working capital, and an allowance for a return on and a return of the value of any nontaxable property that has contributed to the gross operating income. Typical operating expenses and typical management expense include expenses that an owner/operator typically would bear but are borne by the public owner in the case of the subject taxable possessory interest.

d. Allowed expenses do not include the following: amortization, depreciation, depletion charges, debt retirement, interest on funds invested in the taxable possessory interest, the contract rent for the taxable possessory interest, property taxes on the taxable possessory interest, income taxes, or state franchise taxes measured by income.

(D) Capitalization Rate. The capitalization rate may be developed by (i) comparing the anticipated net incomes from comparable taxable possessory interests with their sales prices stated in cash or its equivalent and adjusted as described in subsection (e)(1)(A); (ii) comparing the anticipated net incomes of comparable fee simple absolute interests in real property with their sales prices stated in cash or its equivalent, provided the comparable fee properties are not expected to produce significantly higher net incomes subsequent to the subject taxable possessory interest’s term of possession than during it; or (iii) by deriving a weighted average of the capitalization rates for debt and equity capital appropriate for the subject taxable possessory interest, weighting the separate rates of debt and equity by the relative amounts of debt and equity capital expected to be used by a typical purchaser of the subject taxable possessory interest. Consistent with subsection (f) of rule 8, if a payment for property taxes has not been netted out of the net income to be capitalized, the capitalization rate shall include an added component for property taxes.

(f) Valuation of Pre-De Luz Taxable Possessory Interests. Except as specifically provided otherwise by law, and excluding a taxable possessory interest involving the production of gas, petroleum, or other hydrocarbons, the value of a taxable possessory interest created prior to December 24, 1955, and not since renewed or extended (i.e., a "Pre-De Luz" taxable possessory interest) is the excess of the fair market value on the valuation date of the taxable possessory interest over the present value of unpaid future contract rent for the unexpired term of possession (i.e., for the term of possession). This value may be estimated using one or more of the following methods, as appropriate for the taxable possessory interest being valued.

(1) Comparative Sales Approach to Value. A Pre-De Luz taxable possessory interest may be valued by the comparative sales approach using the direct comparison method or the indirect comparison method, as described in subsection (e)(1), but with the following modifications:

(A) Direct Comparison Method. In the direct comparison method, the present value of the unpaid future contract rent is not added to the sale price of the taxable possessory interest.

(B) Indirect Comparison Method. In the indirect comparison method, the value of the possessor's rights as if owned in fee is reduced by the present value of the unpaid future contract rent of the taxable possessory interest, as well as by the value of those property rights for the period subsequent to the term of possession.

(2) Cost Approach to Value. A Pre-De Luz taxable possessory interest may be valued by the cost approach as described in subsection (e)(2), but the present value of any unpaid future contract rent of the taxable possessory interest in land for the term of possession is also deducted.

(3) Income Approach to Value. A Pre-De Luz taxable possessory interest may be valued by the income approach using the direct income method or the indirect income method, as described in subsection (e)(3), but with the following modifications:

(A) Direct Income Method. In the direct income method, the net income to be capitalized is reduced by the unpaid future contract rent for the term of possession, as well as by allowed expenses.

(B) Indirect Income Method. In the indirect income method, the present value of the unpaid future contract rent for the term of possession is deducted from the value of the fee interest, as well as the deduction of the present value of the property rights for the period subsequent to the term of possession.